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**United States General Accounting Office**
**Washington, DC 20548**

July 1, 2003

The Honorable David L. Hobson
Chairman
The Honorable Peter J. Visclosky
Ranking Minority Member
Subcommittee on Energy and Water Development
Committee on Appropriations
House of Representatives

Subject: *Bonneville Power Administration: Long-Term Fiscal Challenges*

The Bonneville Power Administration (BPA) provides about 45 percent of all electric power consumed in the Pacific Northwest—Idaho, Montana, Oregon, and Washington. The power that BPA markets and distributes is generated in large part at hydroelectric projects including dams in the Federal Columbia River Power System (federal power system). BPA also owns and operates about 75 percent of the region's transmission lines. BPA charges for the power it sells and for its transmission services. Under the Pacific Northwest Electric Power Planning and Conservation Act of 1980, BPA is responsible for ensuring an adequate, efficient, economical, and reliable power supply for the Pacific Northwest. To do so, BPA balances the needs of its customers against the highly variable water resources available for generating electricity. In maintaining this balance, BPA sometimes exchanges power through purchases, sales, or otherwise with utilities and other entities within and outside the Pacific Northwest. In addition to providing power, BPA is required under the 1980 act, various other statutes, treaties and court cases, to "protect, mitigate, and enhance" fish and wildlife resources affected by the federal power system.

Recently, BPA has witnessed a substantial deterioration in its financial condition. For example, BPA's cash reserves of $811 million at the end of fiscal year 2000 had fallen to $188 million by the end of fiscal year 2002. To cope with its financial difficulties BPA has increased the rates that it charges its customers for power by over 40 percent since 2001. In 2002, BPA asked Congress to increase its ceiling on Department of the Treasury (Treasury) debt by about $1.4 billion to fund capital spending and, in 2003, Congress approved a smaller increase of $700 million dollars. In February 2003, BPA announced that it estimated a 74 percent chance that it would miss a Treasury payment this year.

In light of BPA's deteriorating financial condition, request for increased borrowing authority, and increased risk of missing a Treasury payment, you asked us to (1) identify cost advantages, disadvantages, and challenges BPA may face in providing

power and meeting its debt and other obligations; (2) identify the causes of BPA's recent financial difficulties; (3) determine how BPA plans to use its additional borrowing authority; and (4) evaluate how the risk of default to Treasury has changed over the past 5 years. This report presents the preliminary findings of our review of BPA's financial situation and the risk to Treasury. As agreed with subcommittee staff, we will continue to work on these objectives as well as others, including an assessment of options that would enable BPA to reduce the likelihood of future financial difficulties and accompanying risk to Treasury. To perform our work we reviewed BPA budget documents and investment plans, as well as numerous studies and position papers by stakeholders and experts, and we collected views from BPA's customers, stakeholders, and oversight bodies.

**Results in Brief**

- BPA has some inherent advantages that have generally enabled it to provide low-cost power to its customers in the Pacific Northwest and meet debt and other obligations. However, BPA also faces inherent challenges related to meeting its obligations to provide economical power while protecting fish and wildlife. These challenges are made greater by the changing demands on its power and its fish and wildlife protection resources.

- BPA's current financial difficulties are largely the result of decisions that caused rising costs and lower-than-projected revenues. BPA signed long-term contracts to buy power to serve demand that exceeds the supply of the federal power system. Of the additional demand BPA agreed to serve, a significant proportion was for industrial customers that BPA was not required to serve during the fiscal year 2002-2006 rate period. The prices BPA agreed to in these contracts turned out to be significantly higher than recent market prices and were higher than the rates BPA initially set for selling its own power. BPA also projected revenues from its own sale of surplus power that did not materialize when market prices turned out to be lower than BPA had projected.

- BPA plans to use its expanded borrowing authority to upgrade and improve the transmission system and dams in the federal power system. These capital expenditures are expected to increase the reliability and efficiency of the system and may also increase generating capacity to some degree. BPA staff told us that these capital expenditures are, for the most part, not expected to solve BPA's current financial problems.

- We found that BPA's long-term risk of default is greater than in the previous 5-year rate period because of BPA's higher costs and because of uncertainty surrounding both its role as electricity provider and its obligations to protect fish and wildlife. While BPA has taken steps to improve its financial condition and deal with its long-term challenges, in the past such efforts have not entirely succeeded.

## Background

BPA was formed in 1937 to market electric power produced by the Bonneville Dam to the Pacific Northwest. BPA's role in the region has since evolved. BPA's marketing responsibilities were broadened to include power from 31 federally owned hydroelectric projects, most located in the Columbia River Basin. BPA also markets power from one nonfederal nuclear plant and power purchased from other sources. In addition, under the Pacific Northwest Electric Power Planning and Conservation Act of 1980 (Northwest Power Act), BPA is charged with providing the Pacific Northwest with an adequate, efficient, economical, and reliable power supply. In this role, BPA serves its customers' electricity demand at rates that BPA sets to cover its costs, including debt payments and operations-and-maintenance costs.[1] BPA's rates are fixed in the sense that they do not typically vary to reflect changes in the prices of power in the market on an hourly or even daily basis, but rather are set periodically to cover BPA's costs on average over a long period of time. At times when the electricity generation of the federal power system is insufficient to meet the demand of all BPA's customers, BPA has purchased or otherwise acquired power from other sources, including utilities and other suppliers in the Northwest, California, and other western states, to make up the difference. In addition, BPA generates surplus power when demand from its firm customers is low or when water levels are high, and has traditionally exchanged this power under various terms with utilities and other entities in the Northwest and other western states.

The recent restructuring of the nation's wholesale electricity markets has affected how BPA allocates and distributes its surplus power. The electricity industry is in the process of restructuring from one in which monopoly utilities generated and provided electricity to consumers at regulated prices to one in which numerous private companies compete to sell electricity at prices determined by supply and demand conditions. BPA's response to this change has included developing a power trading operation, in part, to sell surplus power as opposed to making exchanges of power.[2]

BPA has additional obligations beyond providing power. For example, the Northwest Power Act also requires that BPA protect, mitigate, and enhance fish and wildlife resources affected by the operation of the federal power system. In addition, significant declines in the historical returns of salmon and steelhead to the Columbia

[1] BPA's customers include public and investor owned utilities. BPA serves the net needs of these customers—the difference between what these customers produce themselves and what they sell to their retail customers. In addition, BPA sells power to some industrial customers. BPA's rates include charges for the electricity BPA generates and for the use of transmission lines that BPA owns.

[2] For example, prior to this change, BPA frequently provided power to California utilities during the spring when BPA had surplus electricity and, in return, the California utilities provided electricity to BPA during the fall and winter when BPA was typically short of electricity. This sort of trading also sometimes took place in a single day; BPA would send power to California utilities during the peak air conditioning hours of the day and receive power back during the night. Now, BPA more commonly sells its surplus power to utilities or power marketers.

River Basin have resulted in the listing of 12 populations of these fish as endangered or threatened under the Endangered Species Act. With these listings, BPA became responsible for ensuring that the operation of the federal power system does not jeopardize the continued existence of these 12 populations. BPA also has a trust responsibility with the 13 federally recognized American Indian tribes in the Columbia River Basin, some of whose fishing rights are guaranteed by treaties, executive order, and court cases. BPA currently provides the bulk of funding for fish and wildlife programs in the Columbia River Basin.

## BPA Has Inherent Cost Advantages and Some Disadvantages and Faces Challenges in Meeting Competing Demands on Its Resources[3]

BPA has inherent cost advantages that have generally allowed it to keep its electricity rates below those of nonfederal utilities in the Pacific Northwest. For example, BPA predominantly relies upon electricity produced at hydroelectric dams in the federal power system, which generally have low capital and operating costs. Many of these projects were built decades ago and had relatively low construction costs compared with newer generating facilities constructed by nonfederal utilities. BPA tends to have lower operating costs in part because, unlike some competing generating units, hydropower projects do not burn fossil fuels.[4] Further, as a federal agency, BPA is not required to pay income taxes. In contrast, according to the Energy Information Administration, investor owned utilities paid taxes averaging between 8.1 and 13.5 percent of operating revenues from 1995 through 2001.[5] In addition, BPA does not include a profit margin in its power rates. In contrast, public utility commissions typically approve a profit margin, in the form of a return to investment, to be included in and thus increase the power rates of investor owned utilities. Moreover, BPA has had access to more favorable financing conditions than investor owned utilities; interest income to bondholders from BPA's nonfederal debt is exempt from federal personal income tax and some state income taxes. In addition, BPA has in the past received favorable loan terms from the Treasury. Finally, these cost advantages have historically benefited the region's electricity consumers and enabled BPA to repay its debt to Treasury and cover other costs, obligations, and debt.

However, BPA also has disadvantages compared with some nonfederal utilities. For example, BPA operates under a different financial structure than investor owned utilities with which it competes. Investor owned utilities can use equity (sale of stock

[3] This section is not intended as a complete enumeration of BPA's advantages, disadvantages, and challenges. Nor have we tried to assess the relative weight or importance of the examples provided in this section.

[4] Many of the newer built generating facilities burn fossil fuels to generate electricity. While the efficiency of fossil fuel burning power plants has generally increased over time, hydroelectric power plants still tend to have cost advantages because of the length of life of dams and the cost of fossil fuels.

[5] While publicly owned utilities typically do not pay income taxes, many do make payments in lieu of taxes to local governments.

or retained earnings) to finance some capital spending. BPA cannot issue stock and generally operates without a profit and, therefore, cannot generally use equity to finance its capital investments. As a result, BPA generally relies on debt for financing capital investments. Carrying higher levels of debt translates into greater average fixed costs that ultimately must be recovered in BPA's power rates. In addition, BPA's obligation to protect, mitigate, and enhance fish and wildlife resources adds to its total costs, thereby increasing its power rates.[6] For example, from fiscal years 1997 through 2001, BPA spent over $1.1 billion in support of fish and wildlife—primarily to benefit salmon and steelhead. These expenditures have funded fish and wildlife efforts, including those undertaken by BPA, other federal agencies, American Indian tribes, and the four northwest states (Idaho, Montana, Oregon, and Washington) and have funded operations-and-maintenance and capital costs for the U. S. Army Corps of Engineers, Bureau of Reclamation, and the Fish and Wildlife Service for projects such as fish bypass facilities at dams and fish hatcheries. BPA also estimates that from fiscal years 1997 through 2001, spilling water from dams and augmenting river flows to enhance fish survival resulted in over $2.2 billion in forgone revenues or increased power purchases.[7]

BPA's dual roles—as supplier of economical and reliable power and as protector of fish and wildlife—present a challenge. BPA's stakeholders include both consumers of electricity and proponents of fish and wildlife protection, and both groups pressure BPA to deliver more of what they want. However, providing more support for fish and wildlife comes at the cost of less electricity and higher electricity rates. Similarly, serving ever-increasing demand for economical electricity can put greater stress on fish and wildlife, either through more intensive use of hydroelectric generating facilities at the expense of spilling water to support fish migration, or through rising costs and the resulting pressure from rate-payers to reduce funding for fish and wildlife programs, as has occurred during the current financial crisis.

BPA, like its competitors, operates in an unstable environment with regard to demand for its electricity and also with regard to its costs for fish and wildlife protection. For example, while the regional demand for BPA's electric power has generally grown throughout BPA's existence, demand for BPA's power fell in the mid-1990s as some of its customers found lower prices in the market. Demand for BPA's power increased dramatically after market prices rose during the western electricity crisis of 2000 and 2001. While other utilities face similarly uncertain demand and market conditions, BPA appears to have greater competing pressure from its various stakeholders. For example, in an April 18, 2003 open letter to its customers and Northwest citizens, BPA stated that it had been influenced by arguments and demands from its stakeholders on such issues as how much power it would provide and how it would structure its power rates. In addition, over the past two decades, BPA's spending and actions in support of fish and wildlife have grown considerably with the enactment of various environmental laws and with increased regulations put

[6] BPA has pointed out that it has other obligations, including providing benefits to customers of investor owned utilities and providing some irrigation assistance.

[7] We have not audited BPA's estimates of foregone revenues or increased power purchases.

in place to protect the environment. BPA provides the majority of fish and wildlife program money in the region, which increases its challenges relative to its competitors.

## BPA's Financial Difficulties Caused by Rising Costs, Lower Than Expected Revenues

BPA's current financial difficulties have been largely caused by decisions resulting in rising costs and lower than projected revenues. In April 2003, BPA estimated that its costs over the current 5-year rate period, covering fiscal years 2002 through 2006, would be $5.3 billion dollars greater than over the previous 5 years. This increase in costs is quite substantial given that BPA's total operating revenues—funds available to cover its costs—were about $13.7 billion over the previous 5-year period from 1997–2001.[8] A large part of the increase in costs is related to serving demand at levels above the estimated average power production of the federal power system during a "critical water year."[9] BPA agreed to serve this additional demand and, to do so, BPA signed long-term contracts to purchase power from other sources.[10] Of the additional demand BPA agreed to serve, a significant proportion was for industrial customers that BPA was not required to serve during the fiscal year 2002-2006 rate period. The prices that BPA paid for the additional power were significantly higher on average than the rates BPA initially set for the current rate period and are also higher than recent market prices. More generally, BPA's costs attributed to both its sale of electric power (power business line) and sale of transmission services (transmission business line) have risen in almost every cost category since 1997. Further, BPA's fish and wildlife expenditures increased from about $80.5 million in fiscal year 1997 to $109.6 million in 2001 in constant 2001 dollars—an increase of about 36 percent—and are projected to be even higher over the next few years. Finally, staffing levels have also increased, from a recent low of 2,738 full-time-equivalent positions (FTEs) in 1999 to an estimated 3,206 in 2003—an increase of about 17 percent.

In April 2003, BPA also projected lower revenues than it had planned for in the original rates set for the current rate period. A large part of this expected revenue shortfall comes from lower than expected market prices. For example, because market prices since the beginning of fiscal year 2002 have been lower than BPA projected, BPA recently estimated that revenues from surplus sales of power would be about $700 million lower than BPA had assumed when setting its initial rates for the rate period.[11] BPA's projected revenues are also lower because of lingering

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[8] Neither the $5.3 billion nor the $14.6 billion figure has been adjusted for inflation.

[9] BPA estimates its available power based on water conditions in a "critical water year." In a critical water year less than normal amounts of water are available to generate hydroelectricity.

[10] These contracts were for periods of up to 5 years. Many of the contracts were signed before and during BPA's formal rate-setting process for the fiscal year 2002–2006 period.

[11] As discussed previously in this report, BPA sometimes has surplus power to sell, even in years when its capacity is insufficient to serve its entire demand.

impacts of the drought of 2000 and 2001, which have reduced the amount of water available to generate surplus electricity.

## BPA Plans to Use Borrowing Authority to Upgrade Transmission and Generation Systems

BPA plans to use the bulk of its borrowing authority to upgrade its transmission system and make other investments to increase system reliability. Specifically, about 62 percent of BPA's planned capital spending is directed at the transmission system. Another about 5 percent of capital spending is for corporate uses, such as information technology investments and projects. The remaining 33 percent is directed toward reliability and efficiency improvements at federally owned dams. Some of these dam improvements will also slightly increase the capacity of the federal power system to produce electricity. Overall, BPA staff told us that while these investments are needed to improve reliability and efficiency, most planned capital investments are largely unrelated to BPA's current financial difficulties and are unlikely to resolve them.

## Risk of Failure to Meet Debt Obligations to Treasury Has Likely Increased As a Result of High Costs and Market Uncertainty

Several factors appear to have increased the risk over the past 5 years that BPA may be unable to meet its full future debt obligations to Treasury. In a 1997 report,[12] we noted that BPA would likely face a higher risk of default on its debt to Treasury after fiscal year 2001 as a result of (1) high fixed costs, [13] which BPA must cover regardless of how much electricity it sells; (2) high operating costs, including internal costs and fish and wildlife protection costs; (3) greater market uncertainty, in part because of the impacts of electricity restructuring on market prices and demand; and (4) an increased likelihood that BPA will lose part of its customer base as its costs increase relative to costs of alternative supplies of electricity. This likelihood of greater risk to Treasury seems to be coming to pass. We found in our current review that BPA's fixed costs are expected to rise over the next few years, that its operating costs are much higher than when the 1997 report was published, that market and other uncertainty affecting BPA's costs and revenues has increased, and that there is significant risk that BPA will lose some of its customer base in the future. Specifically:

- With regard to fixed costs, the 1997 GAO report stated that as of 1996, BPA's high fixed costs inhibited its flexibility to lower its rates and meet competitive

[12] U.S. General Accounting Office, *Federal Electricity Activities: The Federal Government's Net Cost and Potential for Future Losses*, GAO/AIMD-97-110 (Washington, D.C.: Sept. 19, 1997).

[13] Fixed costs are costs that must be paid regardless of how much electricity BPA sells. These fixed costs include meeting long-term debt obligations incurred to build hydro projects, nuclear plants, and the transmission system.

pressures. For example, financing costs for BPA's long-term debt ate up 32 percent of BPA's revenues—compared to a nationwide average of 14 percent for investor owned utilities. Currently, BPA expects its total debt to rise over the next few years as BPA undertakes its planned capital investments on transmission and generation upgrades. This additional debt will increase BPA's fixed costs above current levels. Further, because the bulk of these planned investments are focused on reliability of the transmission system, the investments will have little positive impact on BPA's revenues, while paying off the additional debt obligations will require higher total rates, including electricity and transmission charges.

- With regard to high operating costs, BPA's condition is worse than it was 5 years ago. The 1997 report stated that after 2001 BPA faced potential upward pressure on its operating costs, including fish and wildlife costs. For example, a memorandum of agreement that limited BPA's fish and wildlife protection costs was set to expire in 2001, opening the door to possibly higher costs. Costs have indeed risen since 1997. For example, as discussed previously in this report, costs associated with fish and wildlife protection have increased significantly since 1997, as have most other categories of operating costs.

- BPA also faces greater uncertainty than it did 5 years ago. The 1997 report stated that BPA may face greater market uncertainty in the future, and our current review indicates that market uncertainty has indeed been an increased problem for BPA. For example, as discussed previously, BPA had difficulty making accurate projections of market prices for its surplus power sales and this difficulty led BPA to sign long-term contracts to purchase power at high prices and resulted in a downward revision in BPA's expected revenues from surplus electricity sales. BPA also experienced an unanticipated increase in demand for its power following the 2000–2001 western electricity crisis. Further, BPA faces uncertainty with regard to future fish and wildlife costs with the recent federal court decision that rejected the National Oceanographic and Atmospheric Administration's National Marine Fisheries Service (NOAA Fisheries) 2000 biological opinion—a document setting out how NOAA plans to avoid jeopardizing the existence of certain listed species. Any changes to the operations of these projects resulting from the federal court decision may diminish BPA's ability to control costs and/or earn revenue. For example, physical alterations to dams, changes in how the dams are operated, and changes to river flows or reservoir levels to improve fish survival may increase capital and operations costs for the projects and reduce the flexibility to generate power.

- Finally, there is a significant long-term risk that customers will leave BPA in light of BPA's current financial condition. The 1997 report noted that customers may opt to leave BPA if they can find cheaper power than BPA is offering. The availability of cheaper power depends in part on the cost of generating power by alternative means, such as generation plants fired by natural gas or coal. With regard to natural gas generators, the costs of operating these plants for any constant level of natural gas prices, has decreased significantly in recent years

because of improvements in operating efficiency.[14] In contrast, BPA's current costs, as reflected in its power rates, are at historical highs and are currently higher than regional market prices for wholesale electricity have been in most weeks from January 1, 2002, through March 17, 2003.[15] If demand for BPA's power falls, BPA's revenue may be subject to greater volatility because BPA will have to sell more of the power generated by the federal power system in the market where prices have been quite volatile. Greater revenue volatility increases the risk to Treasury, especially as BPA's debt increases over the next few years.

BPA is currently taking steps to address its financial problems and improve its outlook over the next few years, but the outcome of these efforts is in doubt. For example, BPA is planning to reduce its internal costs. However, past efforts by BPA to reduce internal costs have produced mixed results. For example, in 1996, BPA planned to reduce its staffing level to 2,755 FTEs, down from its staffing level at the time of 3,160 FTEs. While BPA met this goal, achieving an FTE level of 2,738 in 1999, staffing has increased since then and is currently well above 1996 levels.

BPA expects a number of other factors to lead to more favorable financial conditions in the future. For example, BPA hopes that improved water conditions and higher market prices will boost revenues. BPA officials have recently told us that a wet late winter and early spring and somewhat higher market prices for surplus power sales have indeed improved BPA's financial outlook in 2003 and reduced significantly the risk that BPA will miss a Treasury payment this year. However, water and market conditions remain subject to volatility, an ongoing revenue and cost risk for BPA. Further, BPA expects its power acquisition costs to fall as its long-term contracts expire between now and fiscal year 2006. Whether or not this cost reduction occurs depends on market conditions in the future and on how much power BPA buys after 2006.

Another factor that BPA believes mitigates risk to Treasury is that many of BPA's customers have signed contracts requiring them to pay BPA for power, whether or not they take the power. These contracts, referred to as "take-or-pay" contracts, may shield BPA from the risk in the short run that customers will leave if BPA's rates remain high or rise further. Further, the take-or-pay obligation may make it easier for BPA to recover its costs as long as the contracts are in force. However, BPA's high rates may increase the likelihood that it will alienate its customers or drive them to lower cost suppliers in the long term or even out of business in some cases. For

[14] As of January 2003, average natural gas prices for the entire nation at the wellhead were over 50 percent higher than the average in 2002. However, the Energy Information Administration forecasts that natural gas prices will fall in the future from recent levels.

[15] These market prices in the Northwest were obtained from the Energy Information Administration. In addition, we reviewed average monthly prices in the Northwest from January 1997 through December 2001, published by Dow Jones. This review indicated that in 41 out of 60 of these months (about 68 percent), average prices were below BPA's current rates of around $32 per megawatt-hour. These prices are for wholesale electricity sold at the Mid-Columbia hub in the Northwest. Because these prices have not been adjusted for inflation, the number of months that average prices have been lower than BPA's current rates may be less than 41 when measured in constant dollars.

example, a number of BPA's utility and industrial customers filed suit this spring to attempt to stop BPA from imposing further rate increases. In addition, some industrial customers have claimed that they are unable to operate at BPA's current rates and may be forced to close down completely if BPA's rates do not fall. If customers do leave BPA in the long term as their take-or-pay contracts end, this may increase future Treasury risk to the extent that BPA ends up selling a greater proportion of its power in the volatile market.

Finally, BPA is engaged in a regional dialogue with its stakeholders to try to resolve issues regarding how much power BPA will provide and under what terms, as well as how best to assess the risks and distribute the benefits of the federal power system. While the current regional dialogue to deal with BPA's financial problems is a positive step, in the recent past BPA did not adopt key recommendations of a previous regional effort to resolve similar issues. Specifically, in 1996 a comprehensive review of the Northwest energy system, undertaken at the request of the governors of Idaho, Montana, Oregon, and Washington, advocated that BPA limit its role as power supplier by not serving future demand increases beyond the expected generation of the federal power system in a critical water year. However, as discussed previously in this report, BPA did not follow this recommendation when it agreed to serve additional demand during the current rate period. BPA has stated that its decision to depart from the recommendations of the comprehensive review resulted from pressure from its customers.

## Agency Comments and Our Evaluation

We provided the Administrator and CEO of BPA with a draft of this report for comment. In a June 20, 2003 letter (see enclosure), the Vice President for National Relations of BPA provided overall comments on the report. These overall comments relate to BPA's potential to lose customers and to its costs—factors we identified that affect BPA's risk of defaulting on Treasury debt.

Regarding BPA's risk of losing customers, BPA's overall comments state that the risk is no greater and is probably lower than in 1997 because while BPA's rates have risen since 1997, the market price for electricity has risen even faster and because many of BPA's customers have signed long-term contracts requiring them to pay for power whether or not they actually take the power.

We believe that the risk is greater than projected in BPA's comments. We agree that the fundamental advantages of the federal power system—most notably the relative low cost of hydroelectric generation—continue to create an opportunity for BPA to provide economical power to its customers. However, we also believe BPA's large rate increases make alternative supplies of electricity more attractive. Moreover, BPA's power rates are currently over 40 percent higher than they were in the mid-1990s when some BPA customers left to find cheaper power, while the costs of new electricity generation have generally fallen in recent years. While some of these customers returned to BPA during and after experiencing extremely high electricity prices during the western electricity crisis of 2000 and 2001, prices in many months since the crisis have returned to levels much closer to prices in the mid-1990s.

Moreover, we disagree with BPA's statement that market prices rose faster than BPA's rates. While market prices for wholesale electricity were very high by historical standards from about May 2000 through July 2001, for most months between January 1997 and February 2003 market prices of wholesale electricity in the Northwest have been lower than BPA's current power rates of over $32 per MWh, even before BPA's recently announced additional 5 percent rate increase.

With regard to the long-term take-or-pay contracts that many of BPA's customers have signed, we agree that these contracts provide BPA with somewhat of a guarantee that their customers will not leave BPA. However, in our discussions with BPA officials we were told that, in the event of a prolonged period of high water and low electricity market prices, it is likely that BPA will be under pressure from its customers to lower its rates or change the terms of the take-or-pay contracts.

With regard to costs, BPA said in its overall comments that the risk that BPA will default on Treasury debt is mitigated because, among other things, the take-or-pay contracts in conjunction with cost-recovery clauses built into BPA's rate case for fiscal years 2001-2006 protect BPA's ability repay its Treasury debt, and because BPA's Transmission services face virtually no competition and so can recover BPA's costs associated with these services, including its investments in electricity infrastructure funded using Treasury debt.

We do not agree. While take-or-pay contracts in conjunction with cost recovery clauses, in principle, allow BPA to raise its rates unilaterally and prohibit customers from leaving BPA for lower priced power elsewhere, in practice, this is not guaranteed. For example, in spring 2003, a number of BPA's customers, including public utilities and industrial customers filed suits to prevent BPA from implementing additional rate increases. The outcome of these suits has not yet been decided, but if the ruling goes against BPA, then BPA's ability to raise its rates to fully cover its costs and debt obligations may be in question.

We also do not agree that the absence of competition for transmission services in the Northwest mitigates Treasury risk. As stated in this report, higher costs, whether in the transmission or power business lines of BPA, all must be recovered in its rates. Further, as stated in our 1997 report, higher debt—incurred to expand or improve the transmission system—also decreases BPA's flexibility to compete with market prices. Therefore, higher debt on the transmission side potentially makes BPA less competitive.

BPA also made a number of detailed technical comments that addressed, among other things, its roles and responsibilities, the causes of its financial difficulties, additional advantages and disadvantages BPA has compared with its competitors, and actions that BPA has taken to improve its financial condition. We have incorporated these comments as appropriate in our draft.

## Scope and Methodology

In conducting our work, we reviewed BPA budget documents and investment plans, numerous studies and position papers by stakeholders and experts, our past reports. We also met with BPA officials and stakeholders, including public utilities, direct service industrial customers, investor owned utilities, representatives of American Indian tribes, and industry experts. We also met with BPA's oversight bodies, including staff of the Department of Energy and staff of the Northwest Electric Power and Conservation Planning Council. We conducted our review from April through May 2003 in accordance with generally accepted government auditing standards.

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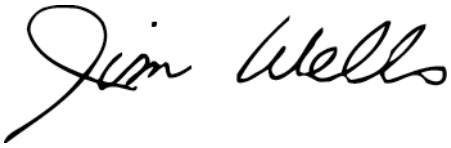
As agreed with your offices, unless you publicly announce the contents of this report earlier, we plan no further distribution of it until 14 days from the report date. At that time, we will send copies of this report to interested Members of Congress and make copies available to others upon request. In addition, the report will be available at no charge on the GAO Web site at http://www.gao.gov.

If you have any questions about this report or need additional information, please call me at (202) 512-3841. Major contributors to this report include Frank Rusco, Jill Berman, Jonathan Dent, Samantha Gross, Jon Ludwigson, Cynthia Norris, and Barbara Timmerman.



Jim Wells
Director, Natural Resources
and Environment

Enclosure

Enclosure

**Department of Energy**

Bonneville Power Administration
Washington, D.C. 20585

June 20, 2003

In reply refer to: KGN-7

Mr. Jim Wells
Director, Natural Resources and Environment
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. Wells:

Thank you for furnishing us with a copy of your proposed draft report entitled Bonneville Power Administration: Long Term Fiscal Challenges (job number 360331). The Bonneville Power Administration (Bonneville) appreciates the opportunity the General Accounting Office (GAO) has provided us to review and comment on the draft you sent us on Tuesday June 17, 2003, and to discuss our comments with GAO staff. Summarizing complex issues such as those dealing with Bonneville's financial matters is challenging. In general, we believe you have done a very good job given the time constraints you were provided. While we have made many comments, there is one area that we want to emphasize in particular. The risk of Bonneville losing customers seems no greater than, and is probably lower than, in 1997. While BPA's rates have risen substantially since 1997, the market price of power has risen even faster. The volatility of west coast power markets has made customers more reticent to move away from a cost-based power product. Recognition also should be given to Bonneville's long-term power sales contracts, signed in 2000, which require customers to pay for power regardless of whether they actually take such power, and the establishment of power rates that include Cost Recovery Adjustment Clauses designed to protect BPA's ability to repay the Federal government on time for its investments in the electricity infrastructure of the region. In addition, Bonneville's Transmission Business Line operates in a regulated monopoly market and faces virtually no competitive pressure.

We understand that time is of the essence and have therefore provided corrections to factual errors, as well as our views, directly within your draft report. Our edits are intended to add clarity and more accurately describe issues. We have also provided more detailed comments, including an update for you regarding our current financial condition and Bonneville's view of recent actions that have been taken.

As we discussed with GAO staff, we believe the inclusion of our comments will improve the clarity of the GAO report and more fairly represent the current status of Bonneville's financial condition. Again, thank you for allowing us the opportunity to comment on the draft report.

Sincerely,

Jeffrey K. Stier
Vice-President for National Relations

Enclosures

(360331)